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Why the *Bank of Canada Act* Needs Updating: A Lesson from the Sub-Prime Crisis

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When trouble in the US housing market this past summer bubbled into problems in credit markets around the world, central banks took action. In a partially successful effort to keep those markets functioning smoothly, several central banks, including the Bank of Canada, took special steps to ensure liquidity – very short-term financing – was available to financial institutions. For the Bank of Canada, these steps included extending the list of securities it would accept as collateral when providing financing.

With some months passed since the beginning of the financial crisis, an evaluation of the Bank of Canada's reaction to events is in order. The Bank's actions offer a lesson about the limitations imposed by the legal framework within which it operates. Specifically, policymakers should reconsider, and quickly, the sections of the *Bank of Canada Act* that govern its open-market operations in emergencies. As recently hinted at by the Bank, Parliament must decide whether the Bank has sufficient ability to provide financial market liquidity.[1] The Bank's actions may have exceeded its statutory authority and, if Parliament believes it necessary that the Bank should have the scope to act as it did, legislative changes are needed.

What Happened?

The recent crisis, an international phenomenon, emerged in early August as falling US real estate prices and growing mortgage foreclosures led investors to re-evaluate short-term debt instruments, such as asset-backed and unsecured commercial paper, and the risks those instruments carried. Financial companies had been using commercial paper

1 Erman, Boyd. 2007. "Central bank eyes wider powers." *The Globe and Mail*, November 21, page B1.

to fund their mortgage lending portfolios. With the health of housing markets increasingly in question, commercial paper holders refused to roll over their investments, and issuers found themselves short of funds. Short-term rates spiked, leading to jitters in other markets, including non-financial asset-backed securities, equities, and corporate bonds.

In reaction to the local manifestations of the growing crisis, the Bank of Canada announced on August 15 that it was expanding the types of securities it would purchase in open-market operations. Usually limited to buying government securities, bills of exchange, and promissory notes, the Bank extended the list to include commercial paper, foreign bonds, and corporate bonds. However, a close reading of the *Bank of Canada Act* suggests that the Bank overstepped its legally mandated boundaries in expanding its list, as I shall explain.

The Bank of Canada engages in two sorts of transactions to influence the rate at which large commercial institutions lend each other reserve funds (the overnight lending rate). The first is the purchase or sale of securities through open-market operations. The Bank specifies a target for the overnight rate and enters into resale and purchase or special purchase and resale agreements (SPRAs) to push rates towards the target. SPRAs are repurchase agreements, or repos, whereby the Bank buys securities from a commercial institution in return for cash, agreeing to sell said securities back to the institution the next day. Though SPRAs act as short-term loans and influence the market for loans, legally they are purchases and sales.

The second type of transaction the Bank engages in is collateralized lending through its Standing Liquidity Facility (SLF). The SLF allows the Bank to lend funds to qualifying financial institutions at what is called the bank rate, accepting sufficient collateral to back its loans. The bank rate is set 0.25 percent above the Bank's target for the overnight rate.

The sorts of securities the Bank of Canada can buy and sell in open-market operations are set out in section 18(k) of the *Bank of Canada Act*.[2] Section 18(k) points to sections 18(c), (e), and (g), which list, as eligible for purchase and sale, Canadian government-issued and guaranteed securities, bills of exchange, and promissory notes.

When it comes to securities eligible as collateral for loans, the Act is less restrictive. Section 18(h) says the Bank can make loans to eligible institutions on "taking security in any property that the institution to which the loan or advance is made is authorized to hold." According to its most recent list, eligible collateral under the SLF includes government issued and guaranteed securities, bills of exchange, promissory notes, as well as commercial paper, foreign bonds, and corporate bonds.

On August 15, the Bank announced that "in addition to accepting Government of Canada securities as collateral for SPRAs, the bank will now accept all securities that are already eligible as collateral for the Bank's SLF." This extended the Bank's purchasing and selling powers beyond government securities, bills of exchange, and promissory notes to include securities listed as eligible collateral under the SLF, including commercial paper, foreign bonds, and corporate bonds.

The blanket extension of 18(h) to SPRAs contradicted sections 18(c), (e), (g), and (k) of the Act pertaining to open-market operations, putting the Bank in questionable legal territory. On September 7, the Bank announced a cessation of the extension introduced on August 15. The reason given: "While money markets continue to

2 *Bank of Canada Act* (R.S.C. 1985, c. B-2).

experience difficulties, there has been significant progress in the functioning of the overnight market."

In making the extension, the Bank seems to have overstepped the Act. The event also highlighted the fact, however, that bills of exchange and promissory notes are outdated financial assets, having been largely replaced by cheques and commercial paper in financial markets. As for the Bank's open-market transactions, government debt instruments such as Treasury bills and bonds have become the preferred securities. This limits the Bank's ability to conduct open-market operations in private sector debt, a power it had in the past and which has not been updated.

What to Do?

Parliament should decide whether it is necessary to change the *Bank of Canada Act* to allow open-market operations to include modern commercial debt securities such as commercial paper, foreign bonds, and corporate bonds. There would be risks associated with such an extension, if market participants came to expect the Bank to provide financial liquidity in an ever-widening set of circumstances, yet clarity on the Bank's authority is nonetheless needed.

Other foreign central banks might provide a model. Much like the Bank of Canada, the United States Federal Reserve can lend on the security of all sorts of collateral, but in open-market operations may only buy or sell government issued or guaranteed debt. The European Central Bank, on the other hand, can buy most commercial debt in open-market operations, including asset-backed commercial paper. Policymakers should consider these two models in determining Canada's path.

It would be doubly unfortunate if the issue goes ignored and, come the next crisis, the Bank again announces an extension of its powers. This would be unfortunate for two reasons. As a matter of principle, arbitrary exercise of power is problematic in any democratic context. Second, while section 18(g.1) of the Act gives the Bank extended buying and selling powers in case of a perceived financial emergency, deploying these powers requires the Governor to publicly state that an emergency exists. He is permitted to delay this declaration if such an announcement would be expected to exacerbate the situation – as typically it would.

This difficulty makes the efficacy of this section questionable. Any future announcement by the Bank giving itself powers beyond its normal mandate could only imply that the Bank believes a crisis is at hand, and that the Governor knows something that observers do not. The confusion that 18(g.1) might cause deserves redress.

The Bank of Canada should offer Canadians a comment on its actions of this past August. Policymakers should also revisit the thinking behind certain sections of the *Bank of Canada Act* including 18(g), which pertains to securities allowed in open-market operations, and 18(g.1), the Bank's emergency buying and selling powers. Failure to do so could hamper the Bank's response the next time the financial system runs into trouble.

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